

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0087 ST
Sales and Use Tax
For The Tax Periods: 1994 through 1996**

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ISSUES

I. Use Tax – Manufacturing Exemption: Electric Distribution Equipment

Authority: IC 6-2.5-2-1; IC 6-2.5-4-1; IC 6-2.5-3-2; IC 6-2.5-5-3; 45 IAC 2.2-5-8

Taxpayer protests the amount of use tax assessed on its purchase of electric distribution equipment.

II. Use Tax – Manufacturing Exemption: Water Treatment Chemicals

Authority: IC 6-8.1-5-1

Taxpayer protests amount of use tax assessed on its purchase of water treatment chemicals.

III. Use Tax – Manufacturing Exemption: Quality Assurance Equipment

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8

Taxpayer protests use tax assessed on its purchase of testing equipment.

IV. Use Tax – Manufacturing Exemption: Refractory Material

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8

Taxpayer protests the amount of use tax assessed on its purchase of refractory material.

V. Use Tax – Manufacturing Exemption: Relining Equipment

Authority: IC 6-2.5-5-6; 45 IAC 2.2-5-8; Rotation Products Corporation v. Indiana Department of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998).

Taxpayer protests use tax assessed on its purchase of relining equipment.

VI. Use Tax – Manufacturing Exemption: Concrete/Steel/Rebar

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8

Taxpayer protests the amount of use tax assessed on its purchase of concrete, steel, and rebar.

VII. Use Tax – Manufacturing Exemption: Cranes

Authority: 45 IAC 2.2-5-8

Taxpayer protests use tax assessed on its purchase of cranes.

VIII. Use Tax – Manufacturing Exemption: Steel-toe Boots

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8

Taxpayer protest use tax assessed on its purchase of steel-toe boots.

IX. Use Tax – Manufacturing Exemption: Pollution Treatment Chemicals

Authority: IC 6-2.5-5-30; IC 6-8.1-5-1

Taxpayer protests use tax assessed on its purchase of pollution treatment chemicals.

STATEMENT OF FACTS

Taxpayer is a secondary steel refinery. Taxpayer uses scrap metal to produce steel coils. Additional facts will be provided as needed.

I. Use Tax – Manufacturing Equipment Exemption: Electric Distribution Equipment

DISCUSSION

Pursuant to IC 6-2.5-2-1, a sales tax, known as state gross retail tax, is imposed on retail transactions made in Indiana. Retail transactions involve the transfer of tangible personal property. IC 6-2.5-4-1. A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC 6-2.5-3-2.

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production . . . manufacture . . . processing . . . or finishing of other tangible personal property. IC 6-2.5-5-3(b). Equipment purchased for direct use in direct production must have an immediate effect on the article being produced. 45 IAC 2.2-5-8(c). Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-8(c).

An electrical distribution system is necessary to operate taxpayer's production process. However, the electrical distribution system performs some non-production activities. Thus, Audit determined that 6% of the electric distribution system's cost was taxable. Taxpayer argues that this percentage is closer to 4%. Taxpayer bases this contention on a study conducted that compared electrical use of the mill during full production with the use during maintenance shutdown. This study showed that the electrical consumption during the shutdown was only 4% of the production total.

However, taxpayer's study does not account for the fact that during full production, some non-exempt consumption takes place. Therefore, the Department finds that audit's original determination was correct.

Taxpayer also argues that they were assessed for payments to certain vendors in the audit and again when the vendors were included in the account calculation referenced above. Taxpayer's protest is sustained upon verification by the audit division.

FINDING

Taxpayer's protest is denied with regards to the electrical distribution equipment and sustained upon verification by the audit division with regards to the vendors being assessed in the audit and again in the account calculation.

II. Use Tax – Manufacturing Equipment Exemption: Water Treatment Chemicals

DISCUSSION

Taxpayer protests use tax assessed on its purchase of water treatment chemicals. Taxpayer purchased water treatment chemicals that are used to treat water that is applied to cool the steel during taxpayer's production process. Audit determined that 15% of these chemicals are taxable because the chemicals were used for purposes other than treating water used in production, e.g., drinking water. Taxpayer argues that these chemicals are "only" used to treat water used in production. Taxpayer submitted a memo from an environmental engineer employed by taxpayer that states the water treatment chemicals at issue are only used in production and that drinking water is not treated with these chemicals.

"The notice of proposed assessment is *prima facie evidence* that the department's claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1 (emphasis added). Although the auditor and taxpayer agreed to the 15% figure during the audit, taxpayer has submitted documentation to rebut the presumption that the 15% taxable figure was correct. The Department finds that the water treatment chemicals at issue are not taxable upon verification by the audit division.

FINDING

Taxpayer's protest is sustained subject to verification by the audit division.

III. Use Tax – Manufacturing Exemption: Quality Assurance Equipment**DISCUSSION**

Taxpayer protests use tax assessed on its purchase of quality assurance equipment. Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax (or use tax) if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. IC 6-2.5-5-3(b). Equipment purchased for direct use in direct production must have an immediate effect on the article being produced. 45 IAC 2.2-5-8(c). Property has an immediate effect on the article being produced if it is an essential and integral part of and integrated process that produces tangible personal property. 45 IAC 2.2-5-8(c). The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative. 45 IAC 2.2-5-8(c)(2).

Taxpayer protests three different types of quality assurance equipment. Each will be discussed separately and a finding will be made with regard to each of the three types of equipment. Taxpayer protests the following three types of equipment: (1) radioactive testing equipment, (2) metallurgy lab equipment, and (3) Qualimatrix system equipment.

Radioactive Testing Equipment. Taxpayer uses radioactive testing equipment to test the radioactive nature of raw materials. Taxpayer stated that this process is essential to its production process because materials containing certain radioactive elements can damage its product and even destroy its entire manufacturing process. Direct use in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required. 45 IAC 2.2-5-8(d). The Department finds that taxpayer's radioactive equipment is used in a pre-production activity; thus, the purchase of equipment used in radioactive testing is subject to Indiana sales and use tax. Therefore, the radioactive testing equipment is subject to tax.

Metallurgy Lab Equipment. Taxpayer performs "on-line" testing of material by using equipment while materials are molten. Taxpayer also tests its product after it has hardened. If the product does not meet specifications at any point, the materials are melted down and reworked through the production process. Taxpayer argues that its metallurgy lab equipment is entirely exempt from tax because it is an essential and integral part of its production process. The Department finds that equipment used in "on-line" testing is exempt from tax because it is essential and integral to taxpayer's production process. However, testing equipment used after the product has hardened is a post-production activity and thus, such equipment is subject to tax.

Qualimatrix System Equipment. Audit assessed tax on only 25% of taxpayer's Qualimatrix system. This equipment is a complex system used for surface testing of steel. For example, cameras are positioned above steel slabs to view surface for appropriate smoothness. The system documents and signals whether the surface is satisfactory; if not, the material is reworked. Taxpayer argues that this entire system should be exempt from tax because the steel is not

saleable unless it is released by quality assurance. However, Audit and taxpayer agreed to the 25% figure during the audit. The auditor based his findings on the determination that a portion of this system was used to test finished products. “The notice of proposed assessment is *prima facie evidence* that the department’s claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.” IC 6-8.1-5-1 (emphasis added). Audit and taxpayer agreed to the 25% figure during the audit. Taxpayer has not submitted documentation to rebut the presumption that the 25% figure was correct. The Department finds that audit’s determination was correct.

FINDING

Taxpayer’s protest is sustained in part and denied in part.

IV. Use Tax – Manufacturing Exemption: Refractory Material

DISCUSSION

Taxpayer protests tax assessed on its purchase of refractory material. Refractory material is used to reline production equipment. It prevents material from attaching to the equipment surface. Audit assessed tax on 10% of this material. Taxpayer contends that audit derived this amount under the assumption that some (10%) refractory material was used to reline an overflow room. However, this overflow room does not need to be relined. Taxpayer argues that all refractory material should be exempt. Yet, a portion of the refractory material was charged to the overflow room capital account. The auditor assessed tax on 10% based on the fact that some refractory material is used in a protective manner on non-production areas. The Department finds that audit’s determination was correct.

FINDING

Taxpayer’s protest is denied.

V. Use Tax – Manufacturing Exemption: Relining Equipment

DISCUSSION

Taxpayer protests use tax assessed on its purchase of relining equipment. Taxpayer uses tundishes and ladles in its production process. These items were exempt from tax. Taxpayer uses relining equipment, which consists of cranes, to transport unusable tundishes and ladles to an area where the equipment can be relined. Taxpayer argues that relining equipment is used to produce exempt equipment. IC 6-2.5-5-6. Taxpayer argues that repairs can constitute production if the repairs are substantial, improve the usefulness of the item being repaired, and are not contemplated as routine maintenance. Rotation Products Corporation v. Indiana Department of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998).

Taxpayer does not produce tundishes or ladles when it relines that equipment. Pursuant to 45 IAC 2.2-5-8(h), maintenance and replacement equipment is not exempted by the manufacturing exemption. Machinery, tools and equipment used in the normal repair and maintenance of

machinery used in the production process which are predominantly used to maintain production machinery are subject to tax. 45 IAC 2.2-5-8(h). Taxpayer's cranes (relining equipment) are used in a manner akin to non-exempt routine maintenance and repair of production equipment. Thus, the relining equipment is subject to tax.

FINDING

Taxpayer's protest is denied.

VI. Use Tax – Manufacturing Exemption: Concrete/Steel/Rebar

DISCUSSION

Taxpayer protests the amount of use tax assessed on its purchase of concrete, steel, and rebar used in production of its manufacturing facility. During the audit, taxpayer and the auditor agreed to certain percentages. However, taxpayer conducted a more concise study that documents a different percentage of taxable material. The Department finds that taxpayer has submitted documentation to substantiate this claim. However, during a supplemental audit, the study should be verified and reviewed to determine its accordance with this Letter of Findings.

FINDING

Taxpayer's protest is sustained subject to audit verification.

VII. Use Tax – Manufacturing Exemption: Cranes

DISCUSSION

Taxpayer protests use tax assessed on its purchase of scrap bay cranes. Scrap bay cranes are used to bring raw materials from the rail cars to the scrap bucket. Taxpayer argues that these cranes are used in part of the production process. Taxpayer argues that scrap bay cranes (1) are used as a measuring tool and (2) are used to transport work-in-process.

Direct use in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required. 45 IAC 2.2-5-8(d). The scrap bay cranes are used prior to the point production begins. As stated above, the radioactive testing equipment used in the scrap bay area was not exempt from tax because it was used during a pre-production activity. Likewise, the scrap bay cranes are used in a pre-production capacity. Thus, the scrap bay cranes are subject to tax.

FINDING

Taxpayer's protest is denied.

VIII. Use Tax – Manufacturing Exemption: Steel-toe Boots**DISCUSSION**

Taxpayer protests use tax assessed on purchase of steel-toed boots. Taxpayer argues that these items are used to protect workers involved in the production process. Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax (or use tax) if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. IC 6-2.5-5-3(b). Equipment purchased for direct use in direct production must have an immediate effect on the article being produced. 45 IAC 2.2-5-8(c). Property has an immediate effect on the article being produced if it is an essential and integral part of and integrated process that produces tangible personal property. 45 IAC 2.2-5-8(c). The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative. 45 IAC 2.2-5-8(c)(2). Safety clothing or equipment, that is required to allow a worker to participate in the production process without injury, is exempt from tax. 45 IAC 2.2-5-8(c)(2)(F).

Taxpayer argues that steel-toed boots are required to allow workers to participate in its production process. Taxpayer's manufacturing process involves heavy industrial equipment. Taxpayer argues that heavy machinery requires workers to use steel-toed boots. In audit, it was understood that workers were responsible for purchasing the steel-toed boots. However, at hearing taxpayer argued that only workers wishing to purchase custom boots were charged for their boots. Otherwise, taxpayer purchased the steel-toed boots as safety equipment for its workers. Due to the nature of taxpayer's production process, protective clothing and equipment is required for workers to participate in the production process. Thus, the Department finds that taxpayer's purchase of steel-toed boots is exempt from tax.

FINDING

Taxpayer's protest is sustained.

IX. Use Tax – Manufacturing Exemption: Pollution Treatment Chemicals**DISCUSSION**

Taxpayer protests use tax assessed on its purchase of pollution treatment chemicals. These chemicals are used to pre-treat process water to comply with local safety regulations. Sales of tangible personal property are exempt from the state gross retail tax if: (1) the property constitutes, is incorporated into, or is consumed in the operation of device, facility, or structure predominantly used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards; and (2) the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture. IC 6-2.5-5-30.

Audit determined that 15% of these chemicals are taxable. Taxpayer argues the chemicals are not used for any taxable functions. However, audit noted that a portion of the chemicals were taxed because they were used for cleaning activities at the facility and not directly used for processing. Additionally, some chemicals were used to slag out waste.

“The notice of proposed assessment is *prima facie evidence* that the department’s claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.” IC 6-8.1-5-1 (emphasis added). Audit and taxpayer agreed to the 15% figure during the audit. The Department finds that audit’s determination was correct.

FINDING

Taxpayer’s protest is denied.